May 12, 2020: A Conversation with Stan Druckenmiller - moderated by Scott Bessent, New York Economic Club

Select quotes by Stan:

· "Everyone thinks liquidity is great, which is why stocks are where they are. But that liquidity dries up… the Fed bought $1T more than the treasury issued. If they stick with what the treasury schedule is, those differences go 0, and then liquidity shrinks as far as the eye can see as treasury borrowing costs crowd out the private market and even the Fed."
· "Maybe the risk reward for stocks is as bad as I have ever seen it in my career. Wildcard is that the Fed can always step up purchases."
· "There's a 50/50 chance we have an operative vaccine by June 2021, but I really have no clue."
· "If we got a vaccine tonight, growth/cloud stocks would be down 10-15%, but would be higher in 2 years, value/old economy would be up 25% tonight, but would be nowhere in 2-3 years."
· "I wouldn't be surprised if these (Corona policy) decisions in 30 years will be the poster child of the worst policy decisions in US history."
· "Opportunity of alpha will be great with great money managers going forward, on a relative basis. I became bearish on the hedge fund industry after I left Duquesne, but now I am as bullish as ever on long short hedge funds - but that's because I'm bearish on almost everything else."

SB: Looking at the stock market, you wouldn't know much has changed vs. 10 months ago. Stocks up, but Fed funds down, yields down. How can this be?

· Stan: Hindsight is wonderful, but the stock market being up is very consistent with market history. A year ago Trump turned up the tariff dial. QT (quantitative tightening) just ended. No sign of QE. Fed made the last rate hike in December. Supposedly neutral going forward.
· S&P estimate this year was 175, now 125. Next year was 193, but this year 160. But the big difference is the Fed has taken fed funds from 225bps to 0. Increased balance sheet from 4T to 8T.
· If one thing I've been quoted for anything, it's the comment I've consistently repeated: "liquidity moves markets much much more than earnings do."
· All the things you are talking about, uncertainty of corona, has been overwhelmed by the Fed rate outlook of 225bps on short end going to 0, and more importantly, the Fed has increased the balance sheet from 4T to 8T.
· QE1, QE2, QE3 were all bullish for stocks. When the fed balance sheet increases that much, and you had the stimulus you just had, that lifts stocks.
· One can say Nasdaq looks strange. NASDAQ was the leading group pre COVID because FANG looked like they were impervious to low nominal growth. Now FANG is not bothered by corona, since most of their earnings are neutral or beneficiaries from COVID. So while S&P earnings went from 175 to 125, their earnings haven't been impacted.
· I know it sounds weird, but the market response is actually quite logical.

SB: So the stock market doesn't need to worry because of liquidity considerations?

· Stan: Risk reward decision is easy. At S&P 2930, you were 20x a moderate recovery case (which was 145 in earnings in 2021), or 17x $172 (5% above 2019 earnings) - but these are aggressive economic assumptions of where will be in 2021.

· Those seem to be high multiples given uncertainty of the virus, the bankruptcies we will have. The Fed has solved liquidity but not solvency. Also the hit to the travel and leisure industries.

· Consensus is don't worry, Fed has your back. Despite everything you are reading, stimulus is good. And liquidity going forward is massive.

· Problem: our analysis says this isn't true. I said earlier, Fed went from $4T to $8T. But while that, the Budget deficit has gone from $1t a year ago to $3.5T today. The April deficit was $780B just by itself. In March and April alone, Fed net of treasury issuance created a $1b of QE. So this is the biggest liquidity injection relative to history I've ever seen.

· Way QE works: the Fed buys $100B worth of bonds. Who is on the other side? People like me. We sell them $100B of treasuries, which is a low risk asset. It is highly unlikely we turn around and put the proceeds all back in treasuries. So that leaks into risky assets. So the bond buying Fed does spill over to risk assets. That's how QE1, QE2, QE3 worked, and how it worked in March/April. You had a stunning unemployment yet the market rallied 33% from the lows.

· So net of the issuance, $1t created, everyone thinks liquidity is great.

· But if you look forward, deficits are starting to get financed. What the Fed bought was $1T more than the treasury issued. If they stick with what the treasury schedule, those differences go 0, and then liquidity shrinks as far as the eye can be seen as treasury borrowing crowds out the private market and even Fed.

· It drives a lot of liquidity to drive a market from 2200 to 2900, reason we got there, should reverse. There is no net new liquidity.

· So risk reward considering we don't know what will happen with the virus, bankruptcies…. maybe risk reward for stocks is as bad as i have seen it in my career.

· Wildcard: Fed can always step up purchases, but i don't know why they would have tapered recently if they were ready to ratchet it right back up.

SB: Mnuchin will eat up all of Jerome Powell's liquidity - what sign posts should we look for?

· Stan: It will show up in the stock market, not the bond market. From QE1 - QE2 was bearish for bonds, bullish for stocks. QT was bearish for stocks, bullish for bonds. The market action should tell you this. If you look at corporate issuance, treasury issuance, then look at the Fed's table and schedule - they tell you their expectations. But you have to be open minded, if the S&P goes back to 2400, the Fed can turn back on the fire again. But I keep going back to Mnuchin allocating companies to Zombie companies and saying this is alright, and it will work out forever...it's unrealistic.

SB: What's your take of Fed grade since mid-March?

· Stan: Fed, A+ since mid March, but not fair to give them that grade leading into the crisis. Let's start earlier. Fed should have raised rates earlier, they would have had more bullets to fire now.

· Many chances to normalize from 2012-present, so a lot of free money. Therefore they had to do more in March/April than they would have to do if they had started raising rates earlier.

SB: And the Treasury?

· Stan: Treasury I will give them a F. We had to do something, but...the fiscal stimulus wasn't anything that built or invested in future growth. It was just a transfer payment paying employees to not work vs. work. And payments to zombie companies to keep them alive.
· 1600 companies in America go under a week when things are fine (most are 1-5 employees). A lot of these companies are now being kept alive. Airlines spent 97% of free cash flow on corporate buybacks, and yes corona wasn't their fault, but none of them would have had issues if they were more prudent.

SB: Will the Fed undertake yield control measures?

· Stan: Fed will need to do what they need to do. Maybe yield control, or QE. Bond market will win out, and rates will be held down low.
· Deflation happens when there is an asset bubble and a bust. We may have cracked the credit bubble as a result of free money.

SB: Should negative rates be part of the solution?

· Stan: Oh God I hope not. You can't have capitalism work without a hurdle rate for investment. It's been tried in Japan, Europe, it's a failure. It cuts off the invisible hand. Somehow we survived 5000 years without negative rates. Geniuses in the Ivy League think it's a wonderful idea. I don't even understand what the argument is.

SB: Trump says we entered the virus with the strongest economy, and we should get back there. Agree or disagree?

· Stan: I wish I agreed with him. God bless him, I hope he is right. Yes unemployment was the lowest in 30-40 years during Trump, and yes it was exciting that people employed had not been able to join the workforce before. But it was a result of reckless spending, a $1.4T deficit with full employment.

SB: What's the mental model you have used for the virus in terms of length, severity.

· Stan I don't have a clue. I'm just a dumb money manager, not a scientist. I'm not sure the scientists have a clue. I have to have a view on this though, since it's driving the markets. There's never been a vaccine for a virus discovered in 4 years. This time, because of the focus and number of geniuses focused on this, and worldwide effort. There is an opinion on my part that it won't take 4 years. I have no clue. There's a 50/50 chance we have an operative vaccine by June 2021. Even if we get it by the end of year, you still need to make billions of these things. So anything operative by June 2021 is 50/50. There have been a ton of coronaviruses before, and they didn't have a vaccine for them. There is a theory that this is a coronavirus from a lab. I'm not optimistic about a vaccine anytime soon. But you could talk to my dog and get the same information. In terms of the remdesivir drug, I'm not sure why the market jumps on that information. I have an 8% chance of dying up from 11% chance of dying? I'm not sure why anyone would change their behavior due to a viral drug. The big wildcard is the government reaction. Other places have shown how poorly the thing has been managed in the US, and how poorly this is managed in the US going forward. Taiwan has 25m people, 6 deaths. Hong Kong has 7.5m people, they have 8 deaths. They are on the border of China. I don't believe Taiwan, our ally didn't tell the US and Trump. So it's tragic how this thing started, but once you got into the virus, I've been continually surprised by the lack of the cost benefit analysis. Taiwan, Hong Kong showed if you put on a mask, social distance, you don't need to shut down the economy. We have 34m people unemployed, and a 100,000 deaths. I'm not saying the deaths aren't important, but I can guarantee you poverty kills, delaying cancer treatments, heart treatments kill. This is one of the most bizarre decision making processes. I wouldn't be surprised if these decisions in 30 years will be the poster child of worst policy decisions in US history.

SB: What about the impact acceleration on businesses and stock selection?

· Stan: The transition to the cloud looked to me like a 10 year runway, and we were 1 year in, at most, 2nd inning. These companies have never been cheap. But it looks like digitization/cloud was like mobile before, a long tail of investment. This is where I was for 4-5 years (long cloud winners), and where I was in february. When this happened, not knowing we would lock down the company. I asked, why isn't Amazon not worth more, not less - rates going to 0, all this stimulus, this will move people to the cloud quicker. Amazon has to be worth more, not less. What i didn't know is we were going to forcibly lock down the entire economy, and company after company - when you ask them what is their biggest surprise around the whole phenomena - it is how unbelievably well they can manage their company remotely. Even industrial companies - companies on the road to digitization - they had an advantage moving to the cloud, now they are moving to the cloud even faster. It's existential. If you aren't on the cloud, you are a goner. So we are jumping to the 4th inning. On the other side of this, 2021-2022 will be a big acceleration period. I think the trend is rational. I feel different than 3-4 weeks ago, a lot of the stocks have doubled since march. So I think the market reaction is rational

· Stan: If we got a vaccine tonight, growth/cloud stocks would be down 10-15%, but would be higher in 2 years, value would be up 25% tonight, but value would be nowhere in 2-3 years. The leaders in the market, the growth companies, have accelerated when to own them in the first place.

SB: Amazon is much aligned, but it pushed all the retailers faster into delviery

· Stan: I have a thing for amazon. I gave a talk on capitalism, I thought it was ridiculous the president attacked the son of an immigrant (Amazon). You have this unbelievable company, made all of our lives better, hired 100,000 people during the crisis, spent $4b during the crisis giving pay raises, they didn't raise their prices on anything . We should just get down on our knees and thank the lord this company existed. Ken Langone told me from Home Depot they made us (Home Depot) a better company, because we had to get online and compete with them.

SB: What should allocation for an endowment or pension fund look like for the next 3 years?

· Stan: Thanks for that one (sarcastic). Make sure the management of whoever they are endowing, understands assumptions of 7-8% returns will be extremely challenged. That would be my first message. With stock multiples, the government getting involved - there will be paybacks for this (in terms of taxes). I can't see the equity market being higher in 3-5 years. How do you deal with that? I'm not sure, every asset class looks tough. I'm hopeful the disruption we've seen in the last 7 years, the acceleration of technology, I don't think that will ever stop. Opportunity of alpha will be great with great money managers going forward, on a relative basis. I became bearish on the hedge fund industry after I left Duquesne, but now I am as bullish as ever on long short hedge funds - but that's because I'm bearish on almost everything else.